CIMA

Subject BA3

Fundamentals of Financial Accounting

Study Text

CIMA Certificate in Business Accounting
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<td>I.1</td>
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Introduction

This document references IFRS® Standards and IAS® Standards, which are authored by the International Accounting Standards Board (the Board), and published in the 2019 IFRS Standards Red Book.
How to Use the Materials

These Kaplan Publishing learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chances of success in your CIMA Cert BA Objective Test Examination.

The product range contains a number of features to help you in the study process. They include:

- a detailed explanation of all syllabus areas
- extensive ‘practical’ materials
- generous question practice, together with full solutions.

This Study Text has been designed with the needs of home-study and distance-learning candidates in mind. Such students require very full coverage of the syllabus topics, and also the facility to undertake extensive question practice. However, the Study Text is also ideal for fully taught courses.

The main body of the text is divided into a number of chapters, each of which is organised on the following pattern:

- **Detailed learning outcomes.** These describe the knowledge expected after your studies of the chapter are complete. You should assimilate these before beginning detailed work on the chapter, so that you can appreciate where your studies are leading.

- **Step-by-step topic coverage.** This is the heart of each chapter, containing detailed explanatory text supported where appropriate by worked examples and exercises. You should work carefully through this section, ensuring that you understand the material being explained and can tackle the examples and exercises successfully. Remember that in many cases knowledge is cumulative: if you fail to digest earlier material thoroughly, you may struggle to understand later chapters.

- **Activities.** Some chapters are illustrated by more practical elements, such as comments and questions designed to stimulate discussion.

- **Question practice.** The text contains exam-style objective test questions (OTQs).

- **Solutions.** Avoid the temptation merely to ‘audit’ the solutions provided. It is an illusion to think that this provides the same benefits as you would gain from a serious attempt of your own. However, if you are struggling to get started on a question you should read the introductory guidance provided at the beginning of the solution, where provided, and then make your own attempt before referring back to the full solution.
If you work conscientiously through this Official CIMA Study Text according to the guidelines above you will be giving yourself an excellent chance of success in your Objective Text Examination. Good luck with your studies!

Quality and accuracy are of the utmost importance to us so if you spot an error in any of our products, please send an email to mykaplanreporting@kaplan.com with full details, or follow the link to the feedback form in MyKaplan.

Our Quality Coordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

**Icon explanations**

- **Definition** – These sections explain important areas of knowledge which must be understood and reproduced in an assessment environment.

- **Key point** – Identifies topics which are key to success and are often examined.

- **Supplementary reading** – These sections will help to provide a deeper understanding of core areas. The supplementary reading is **NOT** optional reading. It is vital to provide you with the breadth of knowledge you will need to address the wide range of topics within your syllabus that could feature in an assessment question. **Reference to this text is vital when self-studying.**

- **Test your understanding** – Following key points and definitions are exercises which give the opportunity to assess the understanding of these core areas.

- **Illustration** – To help develop an understanding of particular topics. The illustrative examples are useful in preparing for the Test your understanding exercises.

- **Exclamation mark** – This symbol signifies a topic which can be more difficult to understand. When reviewing these areas, care should be taken.

- **New** – Identifies topics that are brand new in subjects that build on, and therefore also contain, learning covered in earlier subjects.
Study technique

In this section we briefly outline some tips for effective study during the earlier stages of your approach to the Objective Test Examination. We also mention some techniques that you will find useful at the revision stage. Use of effective study and revision techniques can improve your chances of success in the CIMA Cert BA and CIMA Professional Qualification examinations.

Planning

To begin with, formal planning is essential to get the best return from the time you spend studying. Estimate how much time in total you are going to need for each subject you are studying. Remember that you need to allow time for revision as well as for initial study of the material.

With your study material before you, decide which chapters you are going to study in each week, and which weeks you will devote to revision and final question practice.

Prepare a written schedule summarising the above and stick to it!

It is essential to know your syllabus. As your studies progress you will become more familiar with how long it takes to cover topics in sufficient depth. Your timetable may need to be adapted to allocate enough time for the whole syllabus.

Students are advised to refer to the CIMA website, www.cimaglobal.com, to ensure they are up-to-date.

Students are advised to consult the syllabus when allocating their study time. The percentage weighting shown against each syllabus topic is intended as a guide to the proportion of study time each topic requires.

Tips for effective studying

1. Aim to find a quiet and undisturbed location for your study and plan as far as possible to use the same period of time each day. Getting into a routine helps to avoid wasting time. Make sure that you have all the materials you need before you begin so as to minimise interruptions.

2. Store all your materials in one place, so that you do not waste time searching for items every time you want to begin studying. If you have to pack everything away after each study period, keep your study materials in a box, or even a suitcase, which will not be disturbed until the next time.

3. Limit distractions. To make the most effective use of your study periods you should be able to apply total concentration, so turn off all entertainment equipment, set your phones to silent mode, and put up your ‘do not disturb’ sign.

4. Your timetable will tell you which topic to study. However, before diving in and becoming engrossed in the finer points, make sure you have an overall picture of all the areas that need to be covered by the end of that session. After an hour, allow yourself a short break and move away from your Study Text. With experience, you will learn to assess the pace you need to work at. Each study session should focus on component learning outcomes – the basis for all questions.
(5) Work carefully through a chapter, making notes as you go. When you have covered a suitable amount of material, vary the pattern by attempting a practice question. When you have finished your attempt, make notes of any mistakes you made, or any areas that you failed to cover or covered more briefly. Be aware that all component learning outcomes are examinable.

(6) Make notes as you study, and discover the techniques that work best for you. Your notes may be in the form of lists, bullet points, diagrams, summaries, ‘mind maps’ or the written word, but remember that you will need to refer back to them at a later date, so they must be intelligible. If you are on a taught course, make sure you highlight any issues you would like to follow up with your lecturer.

(7) Organise your notes. Make sure that all your notes, calculations etc. can be effectively filed and easily retrieved later.

Progression

There are two elements of progression that we can measure: how quickly students move through individual topics within a subject; and how quickly they move from one course to the next. We know that there is an optimum for both, but it can vary from subject to subject and from student to student. However, using data and our experience of student performance over many years, we can make some generalisations.

A fixed period of study set out at the start of a course with key milestones is important. This can be within a subject, for example ‘I will finish this topic by 30 June’, or for overall achievement, such as ‘I want to be qualified by the end of next year’.

Your qualification is cumulative, as earlier papers provide a foundation for your subsequent studies, so do not allow there to be too big a gap between one subject and another. For example, E1 Managing finance in a digital world builds on your knowledge of the finance function from certificate level and lays the foundations for E2 Managing performance and all strategic papers particularly E3 Strategic management and P3 Risk management.

We know that exams encourage techniques that lead to some degree of short term retention, the result being that you will simply forget much of what you have already learned unless it is refreshed (look up Ebbinghaus Forgetting Curve for more details on this). This makes it more difficult as you move from one subject to another: not only will you have to learn the new subject, you will also have to relearn all the underpinning knowledge as well. This is very inefficient and slows down your overall progression which makes it more likely you may not succeed at all.

In addition, delaying your studies slows your path to qualification which can have negative impacts on your career, postponing the opportunity to apply for higher level positions and therefore higher pay.
You can use the following diagram showing the whole structure of your qualification to help you keep track of your progress. Make sure you carefully review the 2019 CIMA syllabus transition rules and seek appropriate advice if you are unsure about your progression through the qualification.
Objective Test

Objective Test questions require you to choose or provide a response to a question whose correct answer is predetermined.

The most common types of Objective Test question you will see are:

- multiple choice, where you have to choose the correct answer(s) from a list of possible answers – this could either be numbers or text
- multiple response with more choices and answers, for example, choosing two correct answers from a list of five available answers – this could be either numbers or text
- number entry, where you give your numeric answer to one or more parts of a question, for example, gross profit is $25,000 and the accrual for heat and light charges is $750.
- drag and drop, where you match one or more items with others from the list available, for example, matching several accounting terms with the appropriate definition
- drop down, where you choose the correct answer from those available in a drop down menu, for example, choosing the correct calculation of an accounting ratio, or stating whether an individual statement is true or false
- hot spot, where, for example, you use your computer cursor or mouse to identify the point of profit maximisation on a graph
- other types could be matching text with graphs and labelling/indicating areas on graphs or diagrams.

CIMA has provided the following guidance relating to the format of questions and their marking:

- questions which require narrative responses to be typed will not be used
- for number entry questions, a small range of answers will be accepted. Clear guidance will usually be given about the format in which the answer is required e.g. ‘to the nearest $’ or ‘to two decimal places’
- item set questions provide a scenario which then forms the basis of more than one question (usually 2–4 questions). These sets of questions would appear together in the test and are most likely to appear in BA2 and BA3
- all questions are independent so that, where questions are based on a common item set scenario, each question will be distinct and the answer to a later question will not be dependent upon answering an earlier question correctly
- all items are equally weighted and, where a question consists of more than one element, all elements must be answered correctly for the question to be marked correct.
Throughout this Study Text we have introduced these types of questions, but obviously we have had to label answers A, B, C etc. rather than using click boxes. For convenience we have retained quite a few questions where an initial scenario leads to a number of sub-questions. There will be questions of this type in the Objective Test Examination but they will rarely have more than three sub-questions.

**Guidance re CIMA on-screen calculator**

As part of the CIMA Objective Test software, candidates are provided with a calculator. This calculator is on-screen and is available for the duration of the assessment. The calculator is available in Objective Test Examinations for BA1, BA2 and BA3 (it is not required for BA4).

Guidance regarding calculator use in the Objective Test Examinations is available online at: [https://connect.cimaglobal.com/](https://connect.cimaglobal.com/)

**CIMA Cert BA Objective Tests**

The Objective Tests are a two-hour assessment comprising compulsory questions, each with one or more parts. There will be no choice and all questions should be attempted. The numbers of questions in each assessment are as follows:

- **BA1** Fundamentals of Business Economics – 60 questions
- **BA2** Fundamentals of Management Accounting – 60 questions
- **BA3** Fundamentals of Financial Accounting – 60 questions
- **BA4** Fundamentals of Ethics, Corporate Governance and Business Law – 85 questions

All questions are equally weighted. All parts of a question must be answered correctly for the question to be marked correct. Where questions are based upon a common scenario, each question will be independent, and answers to later questions will not be dependent upon answering earlier questions correctly.

**Structure of subjects and learning outcomes**

Each subject within the syllabus is divided into a number of broad syllabus topics. The topics contain one or more lead learning outcomes, related component learning outcomes and indicative syllabus content.

A learning outcome has two main purposes:

(a) to define the skill or ability that a well prepared candidate should be able to exhibit in the examination

(b) to demonstrate the approach likely to be taken in examination questions.

The learning outcomes are part of a hierarchy of learning objectives. The verbs used at the beginning of each learning outcome relate to a specific learning objective e.g.

**Calculate** the break-even point, profit target, margin of safety and profit/volume ratio for a single product or service.

The verb ‘calculate’ indicates a level three learning objective. The following table lists the learning objectives and the verbs that appear in the CIMA Cert BA syllabus learning outcomes.
## CIMA VERB HIERARCHY

CIMA place great importance on the definition of verbs in structuring objective tests. It is therefore crucial that you understand the verbs in order to appreciate the depth and breadth of a topic and the level of skill required. The objective tests will focus on levels one, two and three of the CIMA hierarchy of verbs. However, they will also test levels four and five, especially at the management and strategic levels.

<table>
<thead>
<tr>
<th>Skill level</th>
<th>Verbs used</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Level 3 Application</strong></td>
<td>Apply</td>
<td>Put to practical use</td>
</tr>
<tr>
<td></td>
<td>Calculate</td>
<td>Ascertain or reckon mathematically</td>
</tr>
<tr>
<td></td>
<td>Conduct</td>
<td>Organise and carry out</td>
</tr>
<tr>
<td></td>
<td>Demonstrate</td>
<td>Prove with certainty or exhibit by practical means</td>
</tr>
<tr>
<td></td>
<td>Prepare</td>
<td>Make or get ready for use</td>
</tr>
<tr>
<td></td>
<td>Reconcile</td>
<td>Make or prove consistent/compatible</td>
</tr>
<tr>
<td><strong>Level 2 Comprehension</strong></td>
<td>Describe</td>
<td>Communicate the key features of</td>
</tr>
<tr>
<td></td>
<td>Distinguish</td>
<td>Highlight the differences between</td>
</tr>
<tr>
<td></td>
<td>Explain</td>
<td>Make clear or intelligible/state the meaning or purpose of</td>
</tr>
<tr>
<td></td>
<td>Identify</td>
<td>Recognise, establish or select after consideration</td>
</tr>
<tr>
<td></td>
<td>Illustrate</td>
<td>Use an example to describe or explain something</td>
</tr>
<tr>
<td><strong>Level 1 Knowledge</strong></td>
<td>List</td>
<td>Make a list of</td>
</tr>
<tr>
<td></td>
<td>State</td>
<td>Express, fully or clearly, the details/facts of</td>
</tr>
<tr>
<td></td>
<td>Define</td>
<td>Give the exact meaning of</td>
</tr>
<tr>
<td></td>
<td>Outline</td>
<td>Give a summary of</td>
</tr>
</tbody>
</table>

### CIMA Cert BA resources

Access to CIMA Cert BA resources including syllabus information is available online at [www.cimaglobal.com](http://www.cimaglobal.com).

### Additional resources

This Study Text is designed to be comprehensive and therefore sufficient to meet the needs of students studying this subject. However, CIMA recognises that many students also want to read around particular topic(s), either to extend their knowledge and understanding, or because it is particularly relevant to their work environment.
CIMA has therefore produced a related reading list for those students who wish to extend their knowledge and understanding, whether for personal interest or to help support work activities as follows:

**BA1 – Fundamentals of Business Economics**
- Principles of Economics 3rd ed. 
  McDowell & Thom
  Griffiths & Wall
  Pemberton & Rau

**BA2 – Fundamentals of Management Accounting**
- Management and Cost Accounting 
  Colin Drury
- Management Accounting 
  Catherine Gowthorpe

**BA3 – Fundamentals of Financial Accounting**
- Financial Accounting – An Introduction 
  Pauline Weetman
- Frank Wood's Business Accounting 1 & 2 
  Frank Wood & Alan Sangster

**BA4 – Fundamentals of Ethics, Corporate Governance and Business Law**
- Students can find out about the specific law and regulation in their jurisdiction by referring to appropriate texts and publications for their country.
  - Managing Responsible Business 
    CGMA Report 2015
  - Global Management Accounting Principles 
    CIMA 2015
  - Embedded Ethical Values: A guide for CIMA Partners 
    CIMA Report 2014
  - Business Ethics for SMEs: A Guide for CIMA Partners 
    CIMA Report 2014
  - Ethics: Ethical Checklist 
    CIMA 2014
  - Ethics Support Guide 
    CIMA 2014
  - Acting under Pressure: How management accountants manage ethical issues 
    CIMA 2012

Information concerning formulae and tables will be provided via the CIMA website, [www.cimaglobal.com](http://www.cimaglobal.com).
SYLLABUS GRIDS

BA3: Fundamentals of Financial Accounting

Syllabus overview

The main objective of this subject is to obtain a practical understanding of financial accounting and the process behind the preparation of financial statements for single entities.

These statements are prepared within a conceptual and regulatory framework requiring an understanding of the role of legislation and of accounting standards. The need to understand and apply necessary controls for accounting systems, and the nature of errors is also covered. There is an introduction to measuring financial performance with the calculation of basic ratios.

Note: Students are required to be aware of the format and content of published accounts but are not required to prepare them. No detailed knowledge of any specific accounting treatment contained in the International Financial Reporting Standards (IFRSs) – including the International Accounting Standards (IASs) – is necessary, except in terms IAS 2 and the treatment of inventory, IAS 16 and IAS 38 for basic non-current asset transactions.

IAS 1 and IAS 7 formats will form the basis of the financial statements. The terminology used for all entities will be that of International Financial Reporting Standards. This will enable students to use a consistent set of accounting terms throughout their studies.

Assessment strategy

There will be a two hour computer based assessment, comprising 60 compulsory objective test questions. Short scenarios may be given to which one or more objective test questions relate.

Syllabus structure

The syllabus comprises the following topics and weightings:

<table>
<thead>
<tr>
<th>Content area</th>
<th>Weighting</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Accounting principles, concepts and regulations</td>
<td>10%</td>
</tr>
<tr>
<td>B Recording accounting transactions</td>
<td>50%</td>
</tr>
<tr>
<td>C Preparation of accounts for single entities</td>
<td>30%</td>
</tr>
<tr>
<td>D Analysis of financial statements</td>
<td>10%</td>
</tr>
<tr>
<td></td>
<td>100%</td>
</tr>
</tbody>
</table>
**BA3A: Accounting principles, concepts and regulations (10%)**

**Learning outcomes**

On completion of their studies, students should be able to:

<table>
<thead>
<tr>
<th>Lead</th>
<th>Component</th>
<th>Level</th>
<th>Indicative syllabus content</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Explain the principles and concepts of financial accounting.</td>
<td>a. Explain the need for accounting records.</td>
<td>2</td>
<td>• Accounting records to be kept and their uses; concept of stewardship.</td>
</tr>
<tr>
<td></td>
<td>b. Identify the needs of different user groups.</td>
<td>2</td>
<td>• Users of accounts and their information needs.</td>
</tr>
<tr>
<td></td>
<td>c. Distinguish between the purposes of financial and management accounts.</td>
<td>2</td>
<td>• Functions of financial and management accounts; purpose of accounting statements.</td>
</tr>
<tr>
<td></td>
<td>d. Explain capital and revenue, cash and profit, income and expenditure, assets and liabilities.</td>
<td>2</td>
<td>• Capital and revenue; cash and profit; income, expenditure, assets and liabilities.</td>
</tr>
<tr>
<td></td>
<td>e. Explain the underlying assumptions, policies and accounting estimates.</td>
<td>2</td>
<td>• Underlying assumptions, policies, accounting estimates; historical cost convention; qualitative characteristics of the Framework, elements of financial statements.</td>
</tr>
<tr>
<td></td>
<td>f. Identify the need for and information to be included in an integrated report.</td>
<td>2</td>
<td>• The principles and elements of the Framework for integrated reporting.</td>
</tr>
<tr>
<td></td>
<td>g. Describe the accounting equation.</td>
<td>2</td>
<td>• The accounting equation formula.</td>
</tr>
<tr>
<td></td>
<td>h. Explain the need for accounting codes.</td>
<td>2</td>
<td>• Use of coding in record keeping.</td>
</tr>
<tr>
<td>2. Explain the impact of the regulatory framework on financial accounting.</td>
<td>a. Explain the influence of legislation and accounting standards on published accounting information.</td>
<td>2</td>
<td>• Regulatory influence of company law; role of accounting standards; IASs and IFRSs; formats for published accounts.</td>
</tr>
</tbody>
</table>
BA3B: Recording accounting transactions (50%)

Learning outcomes

On completion of their studies, students should be able to:

<table>
<thead>
<tr>
<th>Lead</th>
<th>Component</th>
<th>Level</th>
<th>Indicative syllabus content</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>b. Apply the principles of double-entry bookkeeping.</td>
<td>3</td>
<td>• The accounting equation; double-entry bookkeeping rules; journal entries.</td>
</tr>
<tr>
<td></td>
<td>c. Prepare nominal ledger accounts.</td>
<td>3</td>
<td>• Record all types of business transactions in nominal ledger accounts.</td>
</tr>
<tr>
<td></td>
<td>d. Prepare the trial balance.</td>
<td>3</td>
<td>• Completing the trial balance from given ledger account balances.</td>
</tr>
<tr>
<td></td>
<td>e. Explain the nature of accounting errors.</td>
<td>2</td>
<td>• Errors including those of principle, omission, and commission.</td>
</tr>
<tr>
<td></td>
<td>f. Prepare accounting entries for the correction of errors.</td>
<td>3</td>
<td>• Journal entries and suspense accounts.</td>
</tr>
<tr>
<td></td>
<td>g. Prepare accounting entries for non-current assets.</td>
<td>3</td>
<td>• In accordance with IAS 16 – acquisition, depreciation (straight line, reducing balance), revaluation, impairment and disposal of tangibles.</td>
</tr>
<tr>
<td></td>
<td>h. Prepare a non-current asset register.</td>
<td>3</td>
<td>• In accordance with IAS 38 – intangibles and amortisation.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Information to be recorded in a non-current asset register.</td>
</tr>
<tr>
<td>2. Prepare accounting reconciliations.</td>
<td>a. Prepare bank reconciliation statements.</td>
<td>3</td>
<td>• Reconciliation of the cashbook to the bank statement.</td>
</tr>
<tr>
<td></td>
<td>b. Prepare petty cash statements under an imprest system.</td>
<td>3</td>
<td>• Using the imprest system for petty cash.</td>
</tr>
<tr>
<td></td>
<td>c. Prepare sales and purchase ledger control account reconciliations.</td>
<td>3</td>
<td>• Reconciliation of sales and purchase ledger control accounts to sales and purchase ledgers.</td>
</tr>
<tr>
<td>3. Prepare accounting entries for specific transactions.</td>
<td>a. Calculate sales tax.</td>
<td>3</td>
<td>• Calculation of sales tax on all business transactions.</td>
</tr>
<tr>
<td></td>
<td>b. Prepare accounting entries for sales tax.</td>
<td>3</td>
<td>• Accounting entries for sales tax.</td>
</tr>
<tr>
<td></td>
<td>c. Prepare accounting entries for payroll.</td>
<td>3</td>
<td>Note: No knowledge of any specific tax systems/rules/rates will be required.</td>
</tr>
<tr>
<td></td>
<td>d. Prepare accounting entries for the issue of shares.</td>
<td>3</td>
<td>• Accounting entries for basic payroll information.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Note: No knowledge of any specific income tax rules will be required.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Issue at full market price, rights issue and bonus issue.</td>
</tr>
</tbody>
</table>
### BA3C: Preparation of accounts for single entities (30%)

**Learning outcomes**

On completion of their studies, students should be able to:

<table>
<thead>
<tr>
<th>Lead</th>
<th>Component</th>
<th>Level</th>
<th>Indicative syllabus content</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Prepare accounting adjustments.</td>
<td>a. Prepare accounting entries for accruals and prepayments.</td>
<td>3</td>
<td>• Calculations and journals for accruals and prepayments (income and expenses).</td>
</tr>
<tr>
<td></td>
<td>b. Prepare accounting entries for irrecoverable debts and allowances for receivables.</td>
<td>3</td>
<td>• Prepare journals for irrecoverable debts and allowances for receivables from given information.</td>
</tr>
<tr>
<td></td>
<td>c. Prepare accounting entries for inventories.</td>
<td>3</td>
<td>• In accordance with IAS 2 – calculation of the figure for closing inventory for inclusion in the financial statements (FIFO, LIFO and average cost) and the journal entry to record it.</td>
</tr>
</tbody>
</table>
| 2. Prepare manufacturing accounts. | a. Prepare basic manufacturing accounts. | 3 | • Manufacturing accounts produced from given information.  
**Note:** No calculation of overheads and inventory balances is required. |
| 3. Prepare financial statements for a single entity. | a. Prepare financial statements from a trial balance. | 3 | • In accordance with IAS 1 – Statement of profit or loss and other comprehensive income; statement of financial position; statement of changes in equity. |
| | b. Prepare financial statements from incomplete records. | 3 | • Calculate missing numbers using the accounting equation, profit margins and mark-ups, receivables and payables ledgers, and cash and bank ledgers. |
| | c. Prepare a statement of cash flows. | 3 | • In accordance with IAS 7 – operating, investing and financing sections. |
**BA3D: Analysis of financial statements (10%)**

**Learning outcomes**

On completion of their studies, students should be able to:

<table>
<thead>
<tr>
<th>Lead</th>
<th>Component</th>
<th>Level</th>
<th>Indicative syllabus content</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Identify information provided by accounting ratios.</td>
<td>a. Identify the information provided by the calculation of accounting ratios.</td>
<td>2</td>
<td>• Information provided by accounting ratios.</td>
</tr>
<tr>
<td></td>
<td>b. Identify reasons for the changes in accounting ratios.</td>
<td>2</td>
<td>• Reasons for the changes in accounting ratios.</td>
</tr>
<tr>
<td>2. Calculate basic accounting ratios.</td>
<td>a. Calculation of profitability ratios.</td>
<td>3</td>
<td>• Ratios: return on capital employed; gross, operating and net profit margins; non-current asset turnover.</td>
</tr>
<tr>
<td></td>
<td>b. Calculation of liquidity ratios.</td>
<td>3</td>
<td>• Trade receivables collection period and trade payables payment period; current and quick ratios; inventory turnover.</td>
</tr>
<tr>
<td></td>
<td>c. Calculation of risk ratios.</td>
<td>3</td>
<td>• Gearing and interest cover.</td>
</tr>
</tbody>
</table>
The accounting environment

Chapter learning objectives

When you have completed this chapter, you should be able to:

- explain the principles and concepts of financial accounting
- apply the accounting equation to record the effect of transactions
1 Introduction

This chapter provides:

- an introduction to the accounting environment and
- an introduction to the fundamental issues associated with financial accounting.

Much of the chapter relates to the first syllabus area ‘accounting principles, concepts, and regulations’.

This chapter covers:

- the different types of business entity
- the need for accounting records and which accounting records are maintained
- the concept of stewardship
- the user groups of financial accounting information
- the definition of accounting, including use of coding in record keeping
- the differences between financial and management accounting
- the elements of the financial statements
- the accounting equation, including classification of transactions
- the qualitative characteristics of financial information
- the historical cost convention and other valuation bases
- the explanation of accounting concepts and fundamental terms, and
- a glossary of accounting terms.
2 What is a business entity?

A business is an entity that regularly enters into transactions that are expected to provide a reward measurable in monetary terms. It is thus obvious from everyday life that many business entities exist. What is less obvious is that their organisational (legal) structure and therefore their accounting requirements may differ.

There are two main reasons for the different organisational structures that exist – the nature of their activities and their size.

Note that information relating to the different types of entity organisational structure is provided for information and awareness only to provide context and understanding for your financial accounting studies. Many accounting transactions will be common to all types of business entity, such as cash receipts and payments and, therefore, the same accounting principles will apply irrespective of the nature of the business entity.

However, note that you will not be examined on specialised transactions relating to partnerships, local or national government or non-profit making entities. The focus of your studies for this subject is accounting principles and transactions relating to sole traders and companies.

For convenience, and to be consistent with CIMA terminology, reference will usually be made to an 'entity', rather than a 'business' or an 'organisation' or 'company'.

Profit-making entities

Some entities are formed with the intent of making profits from their activities for their owners:

(a) Sole traders (sole proprietors)

Who are they?

These are entities that are owned by one person. They tend to be small because they are constrained by the limited financial resources of their owner. The sole trader will also have unlimited personal liability for debts incurred by the business.

(b) Partnerships

Who are they?

These are entities owned by two or more persons working in common with a view to making a profit. The greater number of owners compared with a sole trader increases the availability of finance and this is often the reason for forming such a structure. As with a sole trader, each of the partners in the business has unlimited personal liability for debts incurred by the business.
Limited liability companies (‘companies’)  

Who are they?

These are entities **recognised in law as ‘persons’ in their own right.** Thus a company may own assets and incur liabilities in its own name. There is a separation in law between ownership of the company by shareholders and its management by directors.

The crucial distinction between a company and either a sole trader or a partnership is that the shareholders of a company have only limited liability for debts incurred by the business, whereas sole traders and partners have unlimited personal liability for debts incurred by the business.

The accounting requirements of companies must meet certain minimum obligations imposed by legislation, for example, via company law and other regulations. Some of these requirements also constitute recommended accounting practice for other types of business entity.

Two types of company can be identified: **private limited companies** and **public limited companies.**

Who are they?

Public limited companies are **‘listed on a stock exchange.’** Listed companies may have many thousands of owners (shareholders) who are even further removed from the running of the business.

In private limited companies the **owners are usually also actively involved in running the business.** In this way they are similar to sole traders and partnerships. This is rarely true of public companies, where the owners are unlikely to be involved in the day-to-day activities of the business. Instead, the shareholders will elect a board of directors to manage the company on a day-to-day basis on their behalf. These distinctions can be important when considering the accounting requirements, which are more onerous for public companies.

The accounting requirements relating to the financial statements of companies are considered in more detail in subsequent chapters of this publication.
Non-profit-making entities

Other entities are formed with the objective of providing services, without intending to be profitable in the long term:

(a) Clubs and societies

Who are they?

These entities exist to provide facilities and entertainments for their members. They are often sports and/or social clubs and most of their revenue is derived from the members who benefit from the club’s facilities and activities. They may carry out some activities that are regarded as ‘trading’ activities, in which profits are made, but these are not seen as the main purpose of the entity. For example, a tennis club may hold a summer barbeque to raise funds for the club.

(b) Charities

Who are they?

These exist to provide services to particular groups, for example people with special needs and to protect the environment. Although they are regarded as non-profit-making, they often carry out trading activities, such as running shops to raise income.

(c) Local and central government

Who are they?

Government departments are financed by members of society (including businesses). Their finances are used to provide the infrastructure in which we live, and to redistribute wealth to other members of society. The accounting requirements of local and central government are not within the syllabus and learning objectives of this subject.

3 The need for accounting records

Accounting records are used to record transactions entered into by an entity, whatever form it may take (e.g. sole trader, partnership, company etc.). This information can then be used to meet a range of needs or requirements as follows:

- they help an entity to record, summarise and classify transactions in a logical and systematic manner
- they help managers to easily locate information required, such as details relating to an individual sales or purchase transaction
- they help managers to easily keep track of amounts owing to the entity from customers and amounts owed to suppliers
• they help managers and owners to meet legal obligations relating to the 
maintenance of accounting records
• they form the basis of preparation of management accounting information 
used by managers for control and decision-making purposes
• they form the basis of financial accounting information used to prepare 
annual accounts for business owners and other interested parties, such as 
tax authorities.

What accounting records are maintained?

In most entities, the principal transactions that take place include sales, 
purchases (of goods and of services) and payroll-related transactions. Other 
transactions include incurring costs for rent, heat and light, fuel and power and 
office expenses such as telephone, postage and stationery. All of these 
transactions (and any others entered into by an entity) must be adequately 
captured by the accounting system to form the basis of preparation of financial 
accounting and management accounting information.

With most transactions a supporting document will be created to confirm that 
the transaction has taken place, when the transaction took place and the 
associated value of the transaction. This documentation is vital to the financial 
accountant, who uses the information on the documents as a data source to 
initiate the measurement and recording of the transactions.

The table below summarises the main types of business documentation and 
sources of data for an accounting system, together with their content and 
purpose.

<table>
<thead>
<tr>
<th>Contents</th>
<th>Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Quotation</strong></td>
<td>Quantity/description/details of goods required. To establish cost from various suppliers and cross refer to purchase order.</td>
</tr>
<tr>
<td><strong>Purchase order</strong></td>
<td>Details of supplier, e.g. name, address. Quantity/description/details of goods required and price. Terms and conditions of delivery, payment, etc. Sent to supplier as request for supply. To check to the quotation and delivery note.</td>
</tr>
<tr>
<td><strong>Sales order</strong></td>
<td>Quantity/description/details of goods required and price. Cross checked with the order placed by customer. Sent to the stores/warehouse department for processing of the order.</td>
</tr>
<tr>
<td><strong>Despatch note (goods despatched note – GDN)</strong></td>
<td>Details of supplier, e.g. name and address. Quantity and description of goods Provided by supplier. Checked with goods received and purchase order</td>
</tr>
<tr>
<td><strong>Goods received note (GRN)</strong></td>
<td>Contents</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>----------</td>
</tr>
<tr>
<td></td>
<td>Quantity and description of goods.</td>
</tr>
</tbody>
</table>

| **Invoice** | Name and address of supplier and customer; details of goods, e.g. quantity, price, value, sales tax, terms of credit, etc. | Issued by supplier of goods as a request for payment. For the supplier selling the goods/services this will be treated as a sales invoice. For the customer this will be treated as a purchase invoice. |

| **Statement** | Details of supplier, e.g. name and address. Includes details of date, invoice numbers and values, payments made, refunds, amount owing. | Issued by the supplier. Checked with other documents to ensure that the amount owing is correct. |

| **Credit note** | Details of supplier, e.g. name and address. Contains details of goods returned, e.g. quantity, price, value, sales tax, terms of credit, etc. | Issued by the supplier. Checked with documents regarding goods returned. |

| **Debit note** | Details of the supplier. Contains details of goods returned, e.g. quantity, price, value, sales tax, terms of credit, etc. | Issued by the business receiving the goods. Cross referred to the credit note issued by the supplier. |

| **Remittance advice** | Method of payment, invoice number, account number, date, etc. | Sent to supplier with, or as notification of, payment. |

| **Receipt** | Details of payment received. | Issued by the selling business indicating the payment received. |


4 The concept of stewardship

Stewardship is a relationship of accountability by one person or group for their management of resources and decision-making on behalf of another person or group (sometimes referred to as a principal). In a financial accounting context, employees (whether managers or directors) are ultimately accountable to the owners of that business (such as shareholders in a corporate entity) for the use of resources under their control and for the outcome of decisions they make in the use of those resources.

Accountability or stewardship is therefore exercised by managers and directors periodically providing financial accounting information to their principal or business owner, normally in the form of annual financial statements.

As such, the steward is placed in a position of trust to manage and account for the resources placed under their control by the principal. Accordingly, they should uphold fundamental ethical principles as follows:

- Integrity
- Objectivity
- Professional competence and due care
- Confidentiality
- Professional behaviour.

Ethical issues are considered in more detail in BA4 Fundamentals of Ethics, Corporate Governance and Business Law.

The stewardship role of management

In a sole trader business or a partnership the owners of the business entity are answerable only to themselves. They own the business entity and they are responsible for its day-to-day operations. In a corporate entity this is not necessarily the case. With the exception of owner-managed companies, it is likely that shareholders do not have any involvement in the day-to-day activities of the running and decision-making of the business entity. They provide the capital and they appoint directors to manage the business entity on their behalf.

In return the directors will receive remuneration in the form of salary and other benefits. The profit generated by the entity, however, belongs to the shareholders. It is the responsibility of the directors/management to ensure that the assets of the entity are safeguarded. This may involve ensuring that:

- all assets are recorded correctly, they exist, and are properly maintained and insured
- procedures are in place to prevent misappropriation or misuse of assets
- the accounting system is efficient and effective
• no expenditure is undertaken, or liability incurred, without proper procedures for its authorisation and control
• the financial statements are prepared in accordance with current legislation and accounting standards.

The term often given to these responsibilities is ‘the stewardship function’. Management acts as stewards on behalf of shareholders, members and other beneficiaries, and may be answerable if they fail in this duty. That is not to say that it is their responsibility to make as much profit as possible, or even that they are to blame if losses are made, but that they must take appropriate steps to manage the risks, within the confines of the business world.

5 Who uses financial information?

Accounting information is used by many discrete groups, both individuals and entities. To develop an understanding of how financial statements may be used, it is useful to classify these users into groups, and to consider the reasons why they use financial statements and what benefit or understanding they hope to gain from doing so.

Any classification of this sort is somewhat arbitrary, and many users fall into more than one classification. However, the following groups are commonly recognised as having particular needs for accounting information.

(a) The investor group

Owners are better able to make decisions regarding their investment (e.g. should they sell shares or retain shares or buy more shares?) if they have relevant information. They are also able to make decisions regarding how the business entity is managed and controlled (e.g. vote to appoint or remove directors).
The accounting environment

What do they require?
This group includes **both existing and potential owners** of shares in corporate entities. They require information concerning the performance of the corporate entity measured in terms of its profitability and the extent to which those profits are to be distributed to shareholders. They are also interested in the social/economic policies of the corporate entity so that they may decide if they wish to be associated with such an entity. For example, does the corporate entity adhere to sound ethical principles and environmental practices?

(b) The lender group

What do they require?
This group includes both **existing and potential providers** of secured or unsecured, long or short-term loan finance. They require information relating to the ability of the entity to repay the interest on such loans as they fall due. Additionally, they are also interested in the longer-term growth and stability of the entity to ensure that it is capable of repaying loans at the due date. In addition, if the loan is secured, the value of the assets used as security is important as a means of recovering the amount due if the entity defaults on repayment.

(c) The employee group

What do they require?
This group includes **current, potential and past employees**. They require information relating to the ability of the entity to pay wages and pensions on a continuing basis. In addition, they are interested in the future prospects of the entity because these issues will affect job security and employment prospects within the entity.

(d) The analyst/adviser group

What do they require?
This group includes a range of **advisers to investors, employees and the general public**. The needs of these users will be similar to those of their clients. The difference is, perhaps, that in some instances, the members of this group will be more technically qualified and experienced to understand and evaluate financial accounting reports.
(e) **The business contact group**

**What do they require?**

This group includes **customers and suppliers** of the entity. Customers will be concerned to ensure that the entity has the ability to provide the goods/services requested and to continue to provide similar services in the future. Suppliers will wish to ensure that the entity will be capable of paying for the goods/services supplied when payment becomes due.

(f) **The government**

**What do they require?**

This group includes **taxation authorities, plus other local and national government agencies and departments**. The taxation authorities will calculate the entity's taxation liability based upon the accounting reports and information submitted. Other government agencies will collect economic and financial data to measure and evaluate national and regional economic performance, such as employment rates and production or output levels.

(g) **The public**

**What do they require?**

This group includes **taxpayers, consumers and other community and special interest groups**. They require information relating to the policies and practices of the entity and how those policies and practices affect the community. For example, the general public has become increasingly aware of, and interested in, the environmental impact a business entity has as a result of its trading activities, and what may be done to minimise any adverse impact. Similarly, the general public has also developed an interest in whether an entity takes advantage of exploitative working and employment practices to minimise operating costs. When an entity is perceived to be operating in a way which is not socially responsible, it may affect the reputation of that entity and also its profitability if, for example, there is a consumer boycott of its products.

(h) **Internal users**

**What do they require?**

The **management of the entity** requires information to assist it in the performance of its duties. Three different levels of management can be identified:

- **Strategic** – this is the most senior level of management within an entity. In a commercial entity it is referred to as the board of directors. This level of management requires information to assist it with major decisions affecting the long-term future of the entity.
• **Tactical** – this is often referred to as middle management. This level of management requires information to support it with monitoring performance and to make decisions to enable the entity to achieve its short- to medium-term targets.

• **Operational** – this is the level of management responsible for decisions which control and manage the day-to-day activities of the entity. It is common for information to be provided to this level of management in non-financial terms, such as hours worked, quantity of components produced, and so on.

Having considered what a business entity is, and who the principal users of financial information are, it is now appropriate to consider what accounting is, how accounting information is recorded and how it is summarised.

6 **An overview: what is accounting?**

![ACCOUNTING CONSISTS OF TWO ELEMENTS](image)

- **Recording**
  - Transactions must be recorded as they occur in order to provide up-to-date information for management.

- **Summarising**
  - The transactions for a period are summarised in order to provide information about the company to interested parties.

What is the objective of recording and summarising accounting transactions and how is that information then used?

The objective of recording and summarising transactions is to provide useful and relevant financial information to the managers, owners and other parties interested in an entity. In the context of financial accounting, this is achieved by the preparation of financial statements.

A significant proportion of the syllabus for this subject deals with the recording, summarising and classifying of accounting transactions to prepare financial statements.
How are accounting transactions recorded and summarised?

Transactions are initially recorded (i.e. listed) in books of prime entry. These books are simply a record of similar transactions recorded in sequential order (e.g. sales made on credit), which are periodically totalled, with the totals posted into the double-entry accounting system. This enables an individual transaction to be captured or recorded in a book of prime entry, whilst minimising the number of entries made in the double-entry accounting system.

This principle will apply regardless of the method used to record accounting transactions. Small entities with relatively few transactions may maintain a manual set of accounting records. Larger entities may enter into hundreds of thousands of transactions each year and they may use computerised accounting records to manage the volume of transactions effectively. Whichever method of maintaining accounting records is used, it will be based upon the same bookkeeping principles.

As each transaction is recorded in a book of prime entry, it will also have a code applied. One common feature of most accounting systems is the use of coding systems that are logical, comprehensive and also flexible enough to enable summarisation and further analysis to be made.

Books of prime entry are considered in further detail later in this publication.

Further detail on accounting

Accounting can be described as being concerned with measurement and management. Measurement is largely concerned with the recording of past data, and management with the use of that data in order to make decisions that will benefit the entity.

The measurement process is not always easy. One of the most common problems is that of when to recognise or record a transaction. For example, if we obtain goods from a supplier with payment due 60 days after the goods have been received, when should that transaction be recorded?

The following possibilities may be considered:

- when the order was placed
- when the goods were received
- when the invoice was received from the supplier; or
- when the supplier was paid.

Accounting, therefore, involves the exercise of judgement by the person responsible for converting data into meaningful information. It is this feature that distinguishes accounting from bookkeeping.
Accounting may be defined as:

- the **classification and recording** of monetary transactions
- the **presentation and interpretation** of the results of those transactions in order to assess financial performance for an accounting period and the financial position at the end of that accounting period
- the **monetary projection** of future activities arising from the alternative planned courses of action.

Note the three aspects considered in this definition: **recording, reporting and forecasting**:

1. Accounting is partly a matter of record-keeping. The monetary transactions entered into by a business entity need to be controlled and monitored, and for this a permanent record is essential. For an efficient system of record-keeping, the transactions must first be classified into categories appropriate to the enterprise concerned.

2. At appropriate intervals, the individual transactions must be summarised as a basis for preparation of statements of financial performance and position of a business entity.

3. Finally, accounting information can be the basis for planning and decision-making.

An alternative explanation is that accounting is part of the management information system (MIS) of an entity. In this context, the accounting element is referred to as an accounting information system (AIS).

Accounting can thus be said to be a method of providing information to management (and other users) relating to the activities of an entity. In order to do this it relies on the accurate collection of data from sources both internal and external to the entity. The recording of this data is often referred to as bookkeeping.
7 Use of accounting information

The accounting system of a business entity records and summarises accounting transactions so that useful information can be prepared for managers and others. Managers need accounting information to help them to manage and control the entity (management accounting) and to prepare financial statements for external users (financial accounting). Normally financial accounting consists of preparing financial statements for external users which comprise the following:

- statement of profit or loss and other comprehensive income – comprises a summary of income and expenses for an accounting period
- statement of financial position – comprises a summary of assets and liabilities and capital at a specific date
- statement of changes in equity – comprises a summary of the movement in capital or equity (i.e. ownership interest) for an accounting period
- statement of cash flows, and
- notes to the financial statements.

This information is crucial to various stakeholders of the business entity, who will analyse that information to make significant economic decisions. It is of vital importance that stakeholders have good quality information to be able to make their decisions.

As you progress through your studies for this subject, you will learn how to record accounting transactions and how to prepare financial statements. Subject BA2 Fundamentals of Management Accounting deals with the use of accounting information for management and control purposes.
8 Financial accounting and management accounting

Financial accounts are produced primarily for owners of business entities and external users. International Accounting Standards (IAS® Standards) and International Financial Reporting Standards (IFRS® Standards) help to reduce the differences in the way that companies draw up their financial statements in different countries.

Management accounts are prepared for managers and others who control the business entity. The key distinctions between financial accounting and management accounting are summarised in the following diagram.

![Diagram showing distinctions between financial accounting and management accounting]

**Financial accounting**

Financial accounting can be described as the classification and recording of monetary transactions of an entity in accordance with established concepts, principles, accounting standards and legal requirements, and their presentation, by means of various financial statements, during and at the end of an accounting period.
Further detail on financial accounting

Two points in particular are worth noting about this description:

1. Financial statements **must comply with accounting rules** published by the various regulatory bodies. In other words, an entity does not have a completely free hand as to how it prepares and presents financial statements. The reason for this is that the financial statements are primarily intended for the use of people outside of the entity. Without access to the more detailed information available to insiders, these interested parties may be misled unless financial statements are prepared based upon uniform principles and standards.

2. Financial accounting is **partly concerned with summarising the transactions of an accounting period and classifying and presenting the summary in a coherent form**. This is because financial statements are intended for use by external third parties. These outsiders have a need for, and a right to receive, specified financial accounting information at defined intervals, and not be subject to the discretion and choice of management.

Management accounting

Management accounting can be described as the process of identification, measurement, accumulation, analysis, preparation, interpretation and communication of information used by management to plan, evaluate and control within an entity and to assure appropriate use of and accountability for its resources.

Further detail on management accounting

Management accounting also comprises the preparation of financial reports for non-management groups such as shareholders, lenders, regulatory agencies and tax authorities.

Although the needs of external users of accounts are addressed in this definition, the emphasis of management accounting is upon providing **information to help managers to control and direct the business entity**. The nature and extent of information produced, and the way in which it is presented, is at the discretion of the managers concerned: they will request whatever information, in whatever format, they believe to be appropriate to meet their needs.
### Internal and external information

Just as distinctions can be made between financial accounting and management accounting, distinctions can also be made between the nature and extent of information available within a business entity for management and control purposes, and information available to external third parties as follows:

<table>
<thead>
<tr>
<th></th>
<th>Internal information</th>
<th>External information</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td><strong>Availability</strong>&lt;br&gt;This is confidential and retained within the entity</td>
<td>This is available to anyone who can access it – usually from a public registry</td>
</tr>
<tr>
<td>2</td>
<td><strong>Frequency</strong>&lt;br&gt;As and when required by the entity e.g. weekly, monthly etc.</td>
<td>Usually annually – as required by law and regulation</td>
</tr>
<tr>
<td>3</td>
<td><strong>Content and format</strong>&lt;br&gt;No standard content or format required – as required to meet business needs. It may be very detailed and may contain budgeted and forecast information, along with financial and non-financial information</td>
<td>Standard format and content set by legislation and technical accounting standards. Typically it is highly summarised with focus upon historical financial information</td>
</tr>
<tr>
<td>4</td>
<td><strong>External audit requirement to provide credibility to information</strong>&lt;br&gt;No external audit requirement</td>
<td>Most companies are required to have an external audit</td>
</tr>
<tr>
<td>5</td>
<td><strong>Compliance with technical accounting standards</strong>&lt;br&gt;There is no requirement for this, although may be desirable to do so</td>
<td>Annual financial statements must comply with technical accounting standards</td>
</tr>
</tbody>
</table>

The remainder of this publication will focus upon financial accounting, and the preparation of financial statements. As a basis for doing this, a number of important accounting terms, principles and concepts need to be defined and explained.
9 Elements of the financial statements

The IASB® Conceptual Framework for Financial Reporting ('Framework') identifies five *elements of the financial statements* as follows:

- **Assets**
  - These elements are used to form the basis of the statement of financial position

- **Liabilities**
  - These elements are used to form the basis of the statement of profit or loss

- **Capital**
  - These elements are used to form the basis of the statement of financial position

- **Income**
  - These elements are used to form the basis of the statement of profit or loss

Each of the elements will now be defined and explained before going on to consider the accounting equation and financial statements in more detail.

The Framework was updated in 2018, and this study text includes updated definitions of the elements of the financial statements.

**Asset**

The IASB Framework defines an asset *a present economic resource controlled by the entity as a result of past events.*

*An economic resource is a right that has the potential to produce economic benefits* (Framework, para 4.2).

This usually means that an asset has been purchased and is owned by the entity. However, be aware that it is possible to have control or use of an asset without owning it, for example, when leasing or hiring an asset.

Further detail on assets

Examples of assets are land, buildings, plant and machinery, motor vehicles, inventories of goods, receivables, bank balances and cash. Assets may be described as **tangible or intangible.** Tangible assets are those that have physical substance and can be seen or touched (e.g. land, buildings, equipment, inventories, etc.). Intangible assets do not have physical substance and cannot be seen or touched (e.g. owning a licence or a brand). Usually intangible assets have some form of legally-based rights or entitlement, such as a patent or registered trademark. You will learn more about intangible assets in Chapters 7 and 8 of this publication.

**Liability**

The IASB Framework defines a liability as *a present obligation of the entity to transfer an economic resource as a result of past events* (Framework, para 4.2).
Further detail on liabilities

Thus a liability can be described as an amount owed by a business entity to an individual or other business entity. Examples of liabilities are payables, loans received and bank overdrafts.

Capital (also known as equity)

The Framework defines equity as 'the residual interest in the assets of the entity after deducting all its liabilities' (Framework, para 4.2).

In this context, capital or equity is not easy to define, but it can be regarded as a special kind of liability that exists between a business entity and its owner(s). In effect, it shows the net amount invested in the business entity by the owner(s) and would be due to them if business activities were terminated.

The above elements can then be arranged into the accounting equation as follows:

\[
\text{Assets} = \text{Liabilities} + \text{Capital}, \text{ or }
\]

\[
\text{Capital} = \text{Assets} – \text{Liabilities}, \text{ or }
\]

\[
\text{Liabilities} = \text{Assets} – \text{Capital}
\]

The accounting equation will be studied in more depth towards the end of this chapter.

Further detail on capital

To return to the accounting equation, you can perhaps see that the assets of an entity have been provided, or 'financed', by liabilities due to either outsiders or to the owners. This emphasises the importance of the separate entity concept described previously. As we regard the owners as being separate from the business entity itself, we can regard the amount owed by the business entity to its owners as a kind of liability. Effectively, we can restate the accounting equation in an even simpler form:

\[
\text{Assets of the business entity} = \text{Liabilities of the business entity}
\]

This statement is always true no matter what transactions the business entity undertakes. Any transaction that increases or decreases the assets of the business entity must increase or decrease its liabilities by an identical amount.
You may be wondering exactly what is meant by saying that capital is an amount ‘owed’ by the business entity to its owners. How can the business entity ‘owe’ anything in this way? How has it incurred a debt?

The answer is that when a business entity commences, it is common for the owners to ‘invest’ some of their private or personal resources into the business. As the business entity operates it generates its own resources in the form of profits, which technically belongs to the owners.

Some of the profit may remain in the business entity, whilst some profit may be withdrawn by the owners in the form of goods or cash. This withdrawal of profits in simple entity structures such as sole traders is known as ‘drawings’.

Income
The Framework defines income as ‘increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from holders of equity claims’ (Framework, para 4.2).

In simple terms, for most business entities this will be sales revenue earned on the sale of goods or provision of services to customers. It could also include other items such as bank interest received.

Expense
The Framework defines expenses as 'decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims' (Framework, para 4.2).

This may occur, for example, when purchasing goods for resale or by incurring operating and other costs such as wages, heat and light charges or repairs to factory machinery.

Capital and revenue transactions
Since the accounting equation makes use of three of the elements of the financial statements as follows:

Assets – Liabilities = Capital

or, it can be re-stated as:

Assets = Capital + Liabilities

It therefore demonstrates the relationships that exist within any business entity. The equation is the basis of one of the most common accounting statements prepared – the statement of financial position.
This equation will form the basis of much of your studies for this subject to record accounting transactions. It will be considered in further detail later in this publication. Consequently, it is important that you understand the following distinctions:

- between capital and revenue transactions, and
- between cash and profit.

### Capital transactions

Capital transactions relate to costs incurred that will affect the entity in the long term, i.e. more than a year.

For the purpose of your studies for this subject we will assume this relates to purchases of non-current assets such as buildings, plant and machinery etc.

Capital costs or capital expenses will **NOT** be included as an expense in the statement of profit or loss but as a non-current asset in the statement of financial position.

### Revenue transactions

Revenue transactions relate to expenses that will only affect the entity in the current accounting period, for example wages, rent payable and vehicle running costs.

Revenue expenses will be included as expenses in the statement of profit or loss and **NOT** in the statement of financial position.

Capital transactions = statement of financial position

Revenue transactions = statement of profit or loss

### Capital and revenue transactions – further information

The word ‘capital’ means different things in different contexts. You have already seen how the word is used to identify the investment by an owner in the business entity. Capital transactions are those that affect the business entity in the long term, as well as in the current period. Capital expenditure is expenditure on non-current assets, and capital receipts would result from the disposal of those assets. Other transactions that are regarded as capital transactions are the obtaining of, and repayment of, non-current finance. Capital transactions initially affect the statement of financial position. Of course, non-current assets are used up over a number of years, and so eventually they will be consumed. We account for this by including depreciation in the statement of profit or loss. You will consider this is more detail as you progress through your studies for this subject.
Revenue transactions

Revenue transactions are those that affect the entity in the current accounting period. Revenue receipts come from sales, and sometimes in the form of income from investments. Revenue expenditure is expenditure on items that are consumed in the current accounting period, for example the running expenses of the entity, cost of sales and so on. Revenue transactions affect the figures in the statement of profit or loss.

Cash and profit

A key point to understand is the difference between cash and profit. 

**Cash** may be regarded as the value of notes and coins (including bank balances) an entity has access to at any point in time. Consequently, cash transactions are accounted for based upon the date of receipt and payment of cash.

**Profit** is the difference between sales revenue less expenses incurred during an accounting period, which is accounted for on an accruals basis. In effect, this means that transactions are accounted for on the date that they are entered into, which may not be the same as the date of receipt or payment of cash. It is explained further elsewhere in this chapter.

The profit or loss for an accounting period will not be matched by an equal increase or decrease in the cash and bank balances of an entity for several reasons. This may be demonstrated by two relatively simple examples as follows:

- consider the situation of a business entity that sells goods on credit for $100. When the sale is made, sales revenue of $100 can be recorded in the accounting records. However, there will not be an equivalent increase in the cash and bank balances until the customer actually pays for the goods at some later date.

- consider the situation of a business entity that purchases new office equipment at a cost of $500, paying cash immediately. This represents the purchase of a non-current asset, and the reduction in the value of another asset (cash and bank balances) by $500. Therefore, this transaction affects only the statement of financial position and does not immediately affect the profit or loss for that accounting period.

As you progress through your studies for this subject, you will come across further examples of transactions which do not have an equal impact upon profit and cash. Some of those transactions are noted below for reference:

- some accounting transactions do not affect the profit or loss for an accounting period, but do affect cash and bank balances, such as:
  - capital introduced into the business entity by the proprietor
  - cash drawings from the business entity by the proprietor
  - purchase of non-current assets, such as property plant and equipment.
• some accounting transactions do affect the profit or loss for an accounting period, but do not affect cash and bank balances, such as:
  – accounting for accruals and prepayments
  – accounting for depreciation
  – accounting for irrecoverable debts and allowances for receivables.

10 The qualitative characteristics of financial information

So far, we have considered who the users of financial information are, and for what purpose they may require financial information. All of the user groups identified, both internal and external to the entity, require that financial information provided should be useful. In this context, information should:

• enable its recipient to make effective decisions
• be adequate for taking effective action to control the entity or provide valuable details relating to its environment
• be compatible with the responsibilities and needs of its recipient
• be produced at optimum cost
• be easily understood by its recipient
• be timely, and
• be sufficiently accurate and precise for the purpose of its provision.

The Framework requires that financial information should have certain qualitative characteristics to ensure that it meets the needs of users. The Framework identifies two fundamental qualitative characteristics and four enhancing qualitative characteristics as follows:

(i) Fundamental qualitative characteristics
   – Relevance
   – Faithful representation.

(ii) Enhancing qualitative characteristics
   – Comparability
   – Verifiability
   – Timeliness
   – Understandability.

Note that the content relating to the qualitative characteristics of useful financial information is relevant in subject F1 Financial Reporting in the CIMA Professional Qualification.
Further detail on qualitative characteristics

For decisions to be made, the information must be relevant to the decision and be clearly presented, stating any assumptions upon which the information is based, so that the user may exercise judgement as appropriate.

Often, better information may be provided at additional cost or after an additional time delay. The adequacy of information is important, and factors such as the cost of the information and the speed with which it is available may be more important than it being 100 per cent accurate.

The information provided must be communicated to the person responsible for taking any action in respect of the information provided. In this regard it is better to distinguish information between that which relates to controllable aspects of business activities and that which relates to non-controllable aspects. The controllable aspects may then be further divided into those that are significant and an exception reporting approach applied.

Fundamental qualitative characteristics

(i) Relevance – Is guided as per the Framework in terms of information becoming relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming or correcting their past evaluations.

The relevance of information can be affected by its nature and materiality. Some items may be relevant to users simply because of their nature whereas some items may only become relevant once they are material. Hence, materiality is a threshold quality of information rather than a primary characteristic.

According to the Framework, information is material if its omission or misstatement could influence the decisions of users.

Materiality – As per the Framework materiality is an entity- specific aspect of relevance and depends on the size of the item or error judged in the particular circumstances of its omission or misstatement.

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements i.e. would an inappropriate decision or judgement be made if information was not available or if it had been misstated?
(ii) **Faithful representation**

In accordance with the Framework is information is to represent faithfully the transactions and other events that it purports to represent, they must be accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

Financial information should possess the following characteristics if it is to faithfully represent the performance and position of a business entity:

**Completeness**

To be understandable information must contain all the necessary descriptions and explanations.

**Neutrality**

Information must be neutral, i.e. free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

**Free from error**

Information must be free from error within the bounds of materiality. A material error or an omission can cause the financial statements to be false or misleading and thus unreliable and deficient in terms of their relevance.

Free from error does not mean perfectly accurate in all respects. For example, where an estimate has been used the amount must be described clearly and accurately as being an estimate.

**Enhancing qualitative characteristics**

The Framework identified that the following items are required as enhancing characteristics of useful financial information:

**Comparability**

Users must be able to compare financial statements over a period of time in order to identify trends in financial position and performance. Users must also be able to compare financial statements of different entities to be able to assess their relative financial position and performance.

In order to achieve comparability, similar items should be treated in a consistent manner from one accounting period to the next and from one entity to another. However, it is not appropriate for an entity to continue accounting for transactions in a certain manner if alternative treatments exist that would be more relevant and reliable.

Disclosure of accounting policies should also be made so that users can identify any changes in these policies or differences between the accounting policies of different entities.
Chapter 1

Verifiability

Verification can be direct or indirect. Direct verification means verifying an amount or other representation through direct observation i.e. counting cash at a specific date. Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology i.e. recalculating inventory amounts using the same cost-flow assumption such as first-in, first-out method.

Timeliness

Timeliness means having information available to decision makers in time to be capable of influencing their decisions. Generally, the older the information is the less useful it becomes.

Understandability

Information needs to be readily understandable by users. Information that may be relevant to decision making should not be excluded on the grounds that it may be too difficult for certain users to understand.

Understandability depends on:

- the way in which information is presented, and
- the capabilities of users.

It is assumed that users:

- have a reasonable knowledge of business and economic activities, and
- are willing to study the information provided with reasonable diligence.

For information to be understandable users need to be able to perceive its significance.

11 The historical cost convention

At what value should transactions be recorded?

Normally, transactions are recorded at historical cost. This is the agreed monetary value of a transaction at the time it takes place. For example, the cost of raw materials purchased from a supplier, or the cost of a machine purchased for use in the business entity. It also applies to sales transactions – they will be recorded at the agreed monetary value when the transaction takes place.

The advantages of using historical cost include:

- it is easily understood by most people
- it is usually easy to reliably identify or determine e.g. by reference to a purchase invoice
- it is an objective basis of measurement, whereas other valuation bases such as fair value or market value are subjective
The disadvantages of using historical cost include:

- it may not be relevant to the needs of some users of financial information who require information based upon current costs and prices
- it may become out of date, particularly when considering the impact of inflation on costs over a period of time
- it presumes that historical cost is based upon a stable unit of currency which enables comparison over time; this is probably not the case.

As you progress through your studies for this subject, you will learn that there are other bases of measuring financial transactions for inclusion in the financial statements, but historical cost is the most comprehensive and commonly used basis of measurement.

---

**Further detail on historical cost**

Traditionally, financial statements have been prepared using the historical cost concept and, to a large extent, still are. This is a system of accounting in which all values are based on the costs incurred or revenue receivable at the date of the transaction.

This means that all of the assets, liabilities, expenses and revenue are recorded using the costs and prices ruling at the date of the transaction as the basis of any accounting entries. This method is objective as each value can be supported by the amount paid to the third party at the date of the transaction.

However, it is accepted that this concept has many shortcomings, and over the years many attempts have been made by accountants to develop alternative valuation or measurement methods. The main difficulty with the concept is that in times of changing price levels, it has the effect of overstating profits and understating asset values.

Consider the purchase of two plots of land: one was purchased 3 years ago for $5,000 and the second plot, identical in terms of size and function, was purchased in the current year for $9,000. If you told an external user that you have two plots of land; one valued at $5,000 and one at $9,000 they would assume that the second plot was either larger or more valuable to the business entity. This, however, is not the case as they are identical. They were simply purchased in different economic circumstances. In this situation, the historical cost concept has painted a misleading picture of the assets of a business entity.

Consider a second example: you purchase a plot of land today for $10,000. You do absolutely nothing to it, leaving it to grow wild. Alternatively, also for $10,000, you could have purchased 100,000 units of your entity's core raw material. Two years later you sell that land, completely untended, for $12,000. With that $12,000 you could now purchase 100,000 units of your entity's core raw material, which has also inflated in value. In the financial statements you record a $2,000 profit upon disposal of the land.
However, ask yourself: has your business entity actually received any increased benefit from owning this land? No: your purchasing power is the same as it was two years previously. So have you really made a profit and is it misleading to the users of the financial statements to suggest as such?

Why is this a problem? Well consider a further example: You set up a business entity and you acquire 10,000 widgets from a supplier at a cost of $10 each, giving a total cost of $100,000. You sell the widgets for $10.50 each, earning revenue of $105,000. You have just made a profit of $5,000; you can pat yourself on the back for some business well done. Or can you?

In the interim period the purchase cost of your widgets has increased to $11. So how many replacement items can you now purchase for your business entity with $105,000? Only 9,545: your business has just shrunk because you have not earned enough revenue to replace your inventory. Ideally, you should have priced your product at $11.50 or more so that you could have replaced all 10,000 items and retained some profit for yourself. It can be seen that the use of the historical cost concept thereby overstates profits and understates statement of financial position asset values. Application of this concept reduces the usefulness of financial statements produced.

The theory of capital maintenance

As seen in the example above; during inflationary times, the profit may only be sufficient to replace inventory, assets and pay for expenses, if the same level of activity is to be maintained. In that case, it is not really a ‘profit’ at all, as we think of profits as being an improvement. Indeed, the profit may not even be sufficient to maintain that level of activity, and – even worse – if some or all of the profits are paid out to the owners of the business entity, the level of activity may have to be reduced. In this case, the business entity has failed to maintain sufficient capital to support the same level of business activity.

Capital maintenance is therefore important as it implies profit is only earned if the value of the entity's net assets or operating capacity has increased during the accounting period. The Framework makes reference to:

- financial capital maintenance – profit is made only if the financial or monetary amount of net assets at the end of the reporting period exceeds the amount at the start of the period, after excluding transactions with owners
- physical capital maintenance – profit is made only if the physical productive capacity of the entity exceeds the physical productive capacity at the start of the period, after excluding transactions with owners.
Whilst historical cost is the most commonly adopted basis for recording transactions, some transactions may be recorded using alternative bases, such as:

- **Fair value** – this may be considered to be the market value of an item i.e. at what price could it be sold?
- **Net realisable value** – this is the estimated selling price of an item, less any further costs that must be incurred in order to make the sale.

These bases, along with the accounting requirements relevant to their application, will be explained in subsequent chapters of this publication as you progress with your studies for this subject.

### 12 The accounting equation in action

The accounting equation is a simple expression of the fact that at any point in time the assets of the entity should be equal to the equity plus the liabilities.

For every transaction that an entity enters into their will be a dual effect. The dual effect principle states that every transaction has two financial effects.

(a) If, for example, you spend $2,000 on a car and pay for it by cheque, you will have $2,000 less money in the bank, but you will have acquired an asset worth $2,000.

(b) Again, if you owe a payable $100 and sent them a cheque for that amount, you will owe $100 less than before, but you will have $100 less money in the bank.

To see the accounting equation in action, study the following worked example.

**Worked Example 1.A**

On 31 March, Ahmed’s employment with GSL came to an end and on 1 April, Ahmed set up in business as a sole trader trading as ‘Ahmed’s Matches’, to sell boxes of matches from a tray on a street corner.

Ahmed deposited $100 into a bank account opened in the name of Ahmed’s Matches. He persuaded a supplier of matches to let him have an initial inventory of 400 boxes, costing 5¢ each, and promised to pay for them one week later.

During his first day of trading he sold 150 boxes at 12¢ each – generating $18 in cash. Feeling pleased, he took $5 from the cash tin and treated himself to supper at the local café.

He also wrote a cheque for $5 to his supplier in part payment for the initial inventory of boxes.

**Required:**

Illustrate the effect of each of these transactions upon the accounting equation.
Solution:

To begin with, the only asset of the business entity was $100 in the business bank account. Capital invested by Ahmed also amounted to $100 and the accounting equation would then be as follows:

\[
\text{Assets} = \text{Liabilities} + \text{Capital}
\]

<table>
<thead>
<tr>
<th>Assets</th>
<th>=</th>
<th>Liabilities</th>
<th>+</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank $100.00</td>
<td>=</td>
<td>0</td>
<td>+</td>
<td>$100.00</td>
</tr>
</tbody>
</table>

The business entity then acquired matches worth $20 with a corresponding liability due to the supplier. The accounting equation now looks like this:

\[
\text{Assets} = \text{Liabilities} + \text{Capital}
\]

<table>
<thead>
<tr>
<th>Assets</th>
<th>=</th>
<th>Liabilities</th>
<th>+</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank $100.00</td>
<td>=</td>
<td>Payables $20.00</td>
<td>+</td>
<td>Capital $100.00</td>
</tr>
<tr>
<td>Inventory</td>
<td>$20.00</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\[
$120.00 = 20.00 + 100.00
\]

When Ahmed sold 150 boxes, he made a profit of (150 × 7¢) = $10.50. His remaining inventory was reduced to 250 boxes at 5¢ each ($12.50). He also acquired a further asset in the process: cash in hand of $18. The accounting equation now looks like this:

\[
\text{Assets} = \text{Liabilities} + \text{Capital}
\]

<table>
<thead>
<tr>
<th>Assets</th>
<th>=</th>
<th>Liabilities</th>
<th>+</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank $100.00</td>
<td>=</td>
<td>Payables $20.00</td>
<td>+</td>
<td>Original capital $100.00</td>
</tr>
<tr>
<td>Cash in hand</td>
<td>$18.00</td>
<td></td>
<td></td>
<td>Profit $10.50</td>
</tr>
<tr>
<td>Inventory (20 – 7.50)</td>
<td>$12.50</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\[
$130.50 = 20.00 + 110.50
\]

Don't forget that when Ahmed sold the inventory we must remove the cost of items sold from the inventory balance, i.e. 150 boxes × 5¢ = $7.50. We can see that the sale had three effects on the accounting equation – inventory was reduced by the cost of the goods sold, i.e. $7.50, cash increased by the amount the goods were sold for, i.e. $18 and the capital balance increased by the profit on the sale amounting to $10.50.
Then Ahmed withdrew $5 from the business entity for his private use. This amount (referred to as drawings) reduced the sum owed to him by the business entity. The accounting equation now looks like this:

\[
\text{Assets} = \text{Liabilities} + \text{Capital}
\]

\[
\begin{align*}
\text{Bank} & \quad $100.00 & \text{Payables} & \quad $20.00 & \text{Original capital} & \quad $100.00 \\
\text{Cash in hand} & \quad (18 - 5) & \quad $13.00 & \quad \text{Profit earned} & \quad $10.50 \\
\text{Inventory} & \quad $12.50 & \quad \text{Less: drawings} & \quad ($5.00) \\
\hline
\text{Total} & \quad $125.50 & \quad $20.00 & \quad $105.50
\end{align*}
\]

Finally, Ahmed made a payment to his supplier, reducing the funds in the business bank account, and also reducing the amount of the liability due to the supplier. The accounting equation now looks like this:

\[
\begin{align*}
\text{Bank} & \quad (100 - 5) & \quad $95.00 & \quad \text{Payables} & \quad (20 - 5) & \quad $15.00 & \quad \text{Original capital} & \quad $100.00 \\
\text{Cash in hand} & \quad $13.50 & \quad \text{Profit earned} & \quad $10.50 \\
\text{Inventory} & \quad $12.50 & \quad \text{Less: drawings} & \quad ($5.00) \\
\hline
\text{Total} & \quad $120.50 & \quad $15.00 & \quad $105.50
\end{align*}
\]

---

Test your understanding 1

J Jones commenced business on 31 January 20X1, transferring $5,000 from her personal bank account into a business bank account. During the first week of February 20X1 the following transactions occurred:

1 Feb Bought motor van costing $800 paying by cheque

2 Feb Bought goods on credit:
   - P Smith $400
   - E Holmes $250

3 Feb Sold goods for cash $600 (cost $400)

4 Feb Banked cash $600
   - Paid P Smith $400 by cheque

5 Feb Sold goods on credit (cost $200)
   - J Amos $200
   - A Turner $300

Required:
Show the accounting equation at the end of each day's transactions.
Accounting coding systems

As a method of summarising and classifying transactions in an organised manner, business entities usually make use of coding systems as part of their record-keeping. Such coding systems enable managers to access relevant information, whether it is an individual transaction, or a group of similar transactions.

By now you will realise that a busy entity will have a large number of ledger accounts and subsidiary records within and outside the accounting system. Using the titles of accounts to locate and cross-reference transactions could be difficult in such situations. Imagine the tax authorities maintaining all the records of individual taxpayers according to their name. There will be hundreds of thousands of taxpayers with the surname Smith, or Khan or Jones – and thousands called John Smith or Helen Jones. Each needs a unique code to identify them from the others. The same applies to accounting systems. The ledger accounts require unique codes, as do inventory items, employees on the payroll and so on.

We could simply number them 1, 2, 3 and so on, but that would not be particularly helpful in locating an individual item. Some kind of coding system is needed. This is particularly important in computerised systems, which use codes to transfer data throughout the system.

Entities could perhaps start with the five main categories of ledger accounts, for example

- Assets Code 1 (e.g. machinery and inventory)
- Liabilities Code 2 (e.g. bank loans)
- Capital Code 3 (e.g. ownership interest in the entity)
- Expenses Code 4 (e.g. wages and heat and light)
- Revenues Code 5 (e.g. sales revenue).

The five categories noted above are referred to as 'the elements of the financial statements' and are defined and explained in this chapter.

This could then be subdivided into more specific categories, for example:

- Non-current assets Code 12 (e.g. machinery)
- Current assets Code 13 (e.g. inventory of goods for sale).

Non-current assets could be further divided into types, for example, plant (1), motor vehicles (2), office equipment (3) and so on.

Codes could be included to identify the location of such items within the entity, e.g. sales department, purchasing department, wages department and factory locations for example. This would enable depreciation to be charged to the department that utilise a particular non-current asset.

The following structure illustrates how a coding system may be used for a nominal ledger in a large entity.
A six-digit code is used: the first digit represents the functional analysis; digits 2 and 3 represent the cost centre (i.e. the department); and digits 4–6 represent the type of expense involved.

<table>
<thead>
<tr>
<th>Function</th>
<th>Cost centre (within production)</th>
<th>Nominal ledger expense analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Production</td>
<td>10 Machining</td>
<td>100 Raw material X</td>
</tr>
<tr>
<td>2 Sales</td>
<td>11 Assembly</td>
<td>101 Raw material Y</td>
</tr>
<tr>
<td>3 Administration</td>
<td>12 Finishing</td>
<td>201 Skilled-labour wages</td>
</tr>
<tr>
<td></td>
<td></td>
<td>202 Unskilled-labour wages</td>
</tr>
<tr>
<td></td>
<td></td>
<td>203 Salaries</td>
</tr>
<tr>
<td></td>
<td></td>
<td>301 Rent</td>
</tr>
<tr>
<td></td>
<td></td>
<td>601 Postage</td>
</tr>
<tr>
<td></td>
<td></td>
<td>602 Stationery</td>
</tr>
</tbody>
</table>

An example code could be 110202, which represents unskilled-labour wage cost incurred in the machining cost centre of the production function.

It is generally accepted that codes should be:

(a) **Unique.** In order to avoid ambiguity, each item must have only one possible code.

(b) **Useful.** There is no point in using a code if there is to be no benefit from its use. The code will need to be logical and understood by those who use and apply it.

(c) **Compact.** It is generally accepted that the shorter the code the easier it is to learn and therefore the likelihood of mistakes and confusion is reduced. Thus, a code should be as short and compact as possible.

(d) **Meaningful.** If the code can be made meaningful by the characters of the code being connected in some way to the item that the code represents, the code will be more easily remembered and understood.

(e) **Self-checking.** The biggest problem with the use of codes is that users of the codes often remember them incorrectly. To ensure that the information provided by the system is of value, each of the codes used must be validated. If a numeric code is used it can be designed in such a way as to be self-checking – this will help in identifying coding mistakes and avoid the processing and production of incorrect information.

(f) **Expandable.** When designing a coding system it is important to consider the requirements of the entity in the future. The design of accounting systems often involves a large amount of time and this is then followed by a period when the users are learning the system. If the code is not expandable, then it is likely that the system will have to be changed sooner rather than later. This will be costly in design time and will cause difficulties because the users of the system will have to learn the new system.
(g) **Standard size.** If codes are of varying size, then different users may write the same code differently. For example, if a part of a coding system comprises up to four characters, then the three-digit code AB1 could be written in a number of ways, with spaces and dashes in different places. Using AB01 would prevent this.

Use of accounting coding systems therefore helps an entity to classify, arrange and summarise its accounting transactions.

### 13 Accounting concepts

This introduction to the accounting environment would not be complete without explanation of some key accounting concepts which you will encounter throughout your accountancy studies. As you consider these concepts, bear in mind that they often require the exercise of judgement and estimation to arrive at reasonable or acceptable monetary values to include in the accounting records when absolute precision may be impossible or very time-consuming to achieve.

The need for concepts reflects the fact that accounting is not a precise science – it requires understanding rather than rote or mechanical learning of techniques. These concepts could form the basis of questions in the examination – either being able to define a concept or to apply it based upon information provided.

Note that accounting concepts may also be referred to as 'accounting principles' or 'accounting conventions'.

**Separate entity concept**

During the discussion of user groups earlier in this chapter, reference was made to the principle that the law recognises a corporate entity as a *person* in its own right, distinct from the personalities of its owners (known as shareholders). This represents application of the 'separate entity' concept, whereby the owners of the business entity are regarded as separate from those who manage and control the activities of the entity.

This concept is applied when recording accounting transactions for any business entity, irrespective of whether there is a legally-recognised separation of ownership and control of that business entity. For example, a sole trader both owns and manages the business entity, but the accounting records are maintained as if the business entity was separate or distinct from its owner. The consequence of applying this concept is that the financial statements prepared for a business entity will present only the financial performance and position of the business entity itself. Any transactions between the owner(s) of the business entity and the entity itself will be reflected within the capital or equity section of the statement of financial position.

For larger entities, this concept also helps to illustrate application of the stewardship relationship between the entity managers/directors who prepare the financial statements for the benefit of the entity owners (shareholders).
Further detail – separate entity concept

Consider the situation of a corporate entity that incurs debts in its own name and then has difficulty in paying them. Its suppliers may be entitled to seize the assets owned by the corporate entity. However, they have no claim against the personal assets owned by the shareholders (the business owners): it is the corporate entity that owes money, not its owners. In law, this distinction does not exist with other forms of business entity, such as the sole proprietor. If Bill Smith is in business as a plumber, trading under the name of ‘Smith & Co. Plumbing Services’, the law recognises no distinction between the business and the individual. If there are debts outstanding for plumbing supplies, and the business assets of Smith & Co. are insufficient to pay them, the suppliers can demand payment from Bill Smith the individual, who may be forced to sell his personal assets – home, car, and so on. In this respect the accounting concept does not correspond with the strict legal form of the business entity. It is an absolutely crucial concept in accounting that, regardless of the legal form of a business entity – corporate entity, sole trader, partnership or whatever – the business entity is treated as a separate entity from its owner(s). For accounting purposes, Bill Smith the individual is not the same as Smith Plumbing Services.

This reflects the fact that accounting information relates only to business transactions. What Bill Smith does as an individual is of no concern to the accountant, and his private transactions must be kept quite separate from the business transactions of Smith & Co. Students sometimes find this concept hard to grasp, particularly when they notice that, as a consequence of it, Bill Smith the individual can actually have business dealings with Smith & Co. For example, Bill may take some copper piping from the inventory held by Smith & Co. in order to repair the heating system in his own home. From the accounting point of view, a business transaction has occurred: Smith & Co. has supplied an individual called Bill Smith with some piping, and its value must be accounted for.

Despite its apparent artificiality, the significance of this concept will become apparent as you progress through your studies for BA3 and apply the principles of the accounting equation.

Accruals or matching concept

This concept refers to the basis upon which income and expenses are recognised in the statement of profit or loss. Income recognised in the statement of profit or loss should be matched with the expenses incurred in earning or generating that inflow of economic benefits to determine the profit or loss for an accounting period. Income is recognised when it has been earned, not when the cash is received from the customer. Expenses are recognised when they are incurred, not when the cash is paid to the supplier. For example, it may be necessary to estimate how many years a machine is likely to be used in the business, so that its cost or usage can be spread over that time period.
This concept will be considered and applied in subsequent chapters of this publication.

**Prudence concept**

This concept refers to the basis upon which items are measured or valued for inclusion in the financial statements. In the statement of financial position, assets should not be overvalued and liabilities should not be undervalued. In the statement of profit or loss, income should be recognised only when it is probable that it will be received, and expenses are recognised as soon as they are incurred. In effect, when there is doubt regarding the precise value of an item for inclusion in the financial statements, caution should be exercised, so that assets and income are not overstated and liabilities and expenses are not understated. For example, it may be necessary to form a judgement on whether any amounts due from credit customers may not be received, and to recognise such amounts as an expense. This concept will be visited throughout subsequent chapters of this publication.

---

**Accounting policies and estimation techniques**

Accounting policies are the principles, conventions, rules etc. applied by a business entity when determining the value at which assets and liabilities, revenue and expenses, will appear in the financial statements. Management should use those policies which it believes will be most useful to those who rely on the financial statements. These users will include, for example, shareholders and lenders, as discussed earlier in this chapter. Management can assess which policies will be most useful by considering the characteristics of useful information, as discussed earlier, including, for example, relevance and reliability.

The implementation of accounting policies requires certain items to be estimated. We can appreciate that the preparation of financial statements relies on judgement and that not all values used can be regarded as definitive or precise. Accountants have developed a number of techniques to arrive at figures which have to be estimated. For example, we will see as we progress through our studies for this subject that a business entity may calculate an allowance for receivables, but this is only an estimate as to which trade receivables may not pay. This allowance is normally calculated based upon assessment of knowledge relating to each specific receivable or customer as appropriate. This is a technique to estimate future irrecoverable debts based upon the information available at that time.

Another example we will encounter in our studies for this subject is depreciation, where the straight-line method and the reducing-balance method are two techniques used to estimate the consumption of a non-current asset in a specific accounting period, over its expected useful life to the business.
Going concern concept

This concept assumes that a business entity will continue to operate for the foreseeable future, which is normally interpreted as being for twelve months following the accounting year end. Application of this concept enables financial statements to be prepared without the need to account for realisable or break-up values of assets and liabilities, which would result in the preparation of financial statements with limited value to users.

The Framework states that this is an underlying assumption when preparing financial statements. If this is not an appropriate assumption, there should be disclosure in the financial statements to explain the basis on which the financial statements have been prepared.

As you progress through your studies for this subject, you will realise that many accounting treatments are based upon application of this concept. For example, when accounting for a non-current asset, an entity will estimate how many years of use that asset will provide so that its cost can be spread over that useful life. This is known as depreciation and will be explained in more detail in the chapters dealing with non-current assets. When accounting for depreciation of non-current assets, it is assumed that there will be future years against which the cost of the non-current asset can be allocated. When calculating accruals and prepayments, it is assumed that the business entity will still be operating in the following accounting period.

Stable monetary unit concept

Accounting information is prepared using monetary measurement, such as dollars or yen. There is a presumption that the monetary value of a currency is stable from one accounting period to the next, which means that financial information can be combined (e.g. to prepare financial statements for an accounting period), or can be compared (e.g. comparison of profitability of a business entity from one accounting period to the next). However, this is not usually the case in the real world as most economies experience inflation (and some experience deflation). Consequently, comparing the statement of profit or loss of a business entity for two consecutive years may mean that any changes are partly due to inflation and not changes in the level of business activity.

Money measurement concept

Application of this concept requires that items are included in the financial statements only if and when they can be reliably measured in monetary terms. For example, many business entities refer to their employees as one of their greatest assets. However, the monetary value of employees to the business entity (as distinct from their payroll costs) cannot be reliably determined, and therefore are not included as assets in the statement of financial position.
Monetary measurements are used because if all the items covered by an accounting statement are stated as an amount of money, then the cost of the items can be identified and their aggregate cost determined. Therefore, there is a unity of meaning that makes financial statements readily understood and provides a common denominator for financial analysis.

**Materiality concept**

Materiality is a concept applied to the preparation of annual financial statements for investors and other external interested parties. Information is regarded as material if its omission or misstatement will change the view presented by the financial statements: in other words, it may lead users of financial statements to make inappropriate judgements or decisions based upon that financial information. Materiality is also a threshold quality such that only material items and values are presented in the financial statements, with immaterial or insignificant information summarised, aggregated or omitted from being reported in the financial statements. This allows users to focus upon the material or significant information that is relevant to them.

For example, consider the situation of a business entity that had an inventory valuation of $917,148 at the end of the accounting year. Would this valuation be materially or significantly misstated if it was included in the annual accounts at a rounded amount of, say, $917,000, or expressed in another way as $0.9m? Hopefully, you can form a judgement that some degree of approximation or rounding does not materially or significantly change the inventory valuation reported in the annual accounts and can still be regarded as reliable information for users of financial statements.

Thus the materiality concept should make the financial statements relevant to users. The distinction between what is significant and what is not varies depending on the size of the entity, and is a matter of judgement. Determining at what point an item becomes material depends partly on value, partly on the nature of the item concerned and partly on its effect on the results that will be reported.

**The consistency concept**

The consistency concept states that the accounting treatment of like items should be accounted for in the same way, within an accounting period and from one accounting period to the next. The usefulness of financial accounting lies to a considerable extent in the conclusions that may be drawn from the comparison of the financial statements of one year with those of a preceding year, or of one entity with another.

Much of the information thus derived would be meaningless if the choice of accounting methods were not applied consistently year by year. An example of an accounting issue where consistency is important is the method of valuation of inventory which is stated at the lower of cost and net realisable value.
The objectivity concept

Financial statements should not be influenced by the personal bias of the person preparing them. Thus, figures used in financial statements should be objective. Ideally, this should mean that any two accountants would produce the same figure, for example, for profit. In practice, there is always some judgement when preparing financial statements but when exercising that judgement the accountant should be neutral and not try to produce, for example, a larger, or smaller, profit to benefit his/her own purposes. Financial statements which are objective should be reliable.

The dual aspect concept

This concept is the basis of double-entry bookkeeping and it means that every transaction entered into has a dual effect on the position of the entity as recorded in the ledger accounts at the time of that transaction.

The realisation concept

This concept states that we recognise sales revenue as having been earned at the time when goods or services have been supplied, i.e. when the contractual obligation has been satisfied. In basic terms, sales are realised when the right to receive revenue has been earned by the reporting entity. If income has been earned but not yet received we should also recognise a matching asset as well as the sales revenue. The asset represents the right to receive benefit (usually cash), from the customer.

Although not within the BA3 syllabus, the following illustration demonstrates this concept well. Consider the situation of goods sold on a 'sale-or-return' basis. The goods are not strictly 'sold' until they have been accepted by the buyer or the deadline for their return has passed. Strictly speaking the sale of these goods should only be recognised by a business entity when it is virtually certain that the goods will not be returned and the sale transaction is therefore regarded as complete.

The periodicity concept

It can be argued that the only correct measurement of an entity’s profitability is that which is made at the end of the entity’s life. However, there is a need to assess the financial position (i.e. statement of financial position) and performance (i.e. statement of profit or loss) of an entity during its life by producing periodic financial statements. This concept enables comparisons to be made between one accounting period and another.
Chapter 1

14 Glossary of terminology

CIMA is an international qualification. Consequently, it is important that the terminology used in the examination is standardised to ensure understanding and to avoid confusion.

The majority of this terminology is sourced from IAS 1 Presentation of Financial Statements and IAS 7 Statement of Cash Flows. However, there are some terms in other areas of the syllabus which may have more than one meaning in different countries.

The table below summarises some of the official terminology used by CIMA, along with examples of alternative terms which may be use in countries around the world to aid student understanding.

<table>
<thead>
<tr>
<th>CIMA Terminology</th>
<th>Examples of alternative terminology</th>
</tr>
</thead>
<tbody>
<tr>
<td>Concept</td>
<td>Convention</td>
</tr>
<tr>
<td>Separate entity concept</td>
<td>Business entity concept</td>
</tr>
<tr>
<td>Dual effect concept</td>
<td>Dual aspect concept</td>
</tr>
<tr>
<td>Not-for-profit organisation/entity</td>
<td>Non-trading organisation/entity</td>
</tr>
<tr>
<td>Nominal ledger</td>
<td>General ledger</td>
</tr>
<tr>
<td>Cashbook</td>
<td>Bank/Cash account</td>
</tr>
<tr>
<td>Sales tax</td>
<td>Value added tax, central sales tax, service tax, goods and services tax</td>
</tr>
<tr>
<td>Social security tax</td>
<td>National insurance</td>
</tr>
<tr>
<td>Income tax</td>
<td>Corporation tax (entities), Pay as You Earn (PAYE) (individuals)</td>
</tr>
<tr>
<td>Inventory</td>
<td>Stock</td>
</tr>
<tr>
<td>Irrecoverable debts</td>
<td>Bad debts</td>
</tr>
<tr>
<td>Allowance for receivables</td>
<td>Provision for doubtful debts</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>Provision for depreciation</td>
</tr>
<tr>
<td>Loan notes</td>
<td>Loan stock, debentures</td>
</tr>
<tr>
<td>Sales ledger</td>
<td>Debtors' ledger, receivables' ledger</td>
</tr>
<tr>
<td>Purchase ledger</td>
<td>Creditors' ledger, payables' ledger</td>
</tr>
<tr>
<td>Returns inwards</td>
<td>Sales returns</td>
</tr>
<tr>
<td>Returns outwards</td>
<td>Purchase returns</td>
</tr>
<tr>
<td>Sales ledger control account</td>
<td>Debitos' ledger control account, receivables' ledger control account</td>
</tr>
<tr>
<td>Purchase ledger control account</td>
<td>Creditors' ledger control account, payables' ledger control account</td>
</tr>
</tbody>
</table>
15 Chapter summary

In this chapter you have studied:

- the need for accounting records to meet the information needs of different user groups
- the different types of business entity
- the qualitative characteristics of useful financial information
- the historical cost convention and alternative bases of valuation
- some fundamental terms associated with financial accounting.
Test your understanding questions

Test your understanding 2

The main aim of accounting is to:
A maintain ledger accounts for every transaction
B provide financial information to users of such information
C produce a trial balance
D record every financial transaction individually

Test your understanding 3

The main aim of financial accounting is to:
A record all transactions in the books of account
B provide management with detailed analyses of costs
C present the financial results of the entity by means of recognised statements
D calculate profit

Test your understanding 4

Financial statements differ from management accounts in that they:
A are prepared monthly for internal control purposes
B contain details of costs incurred in manufacturing
C are summarised and prepared mainly for external users of accounting information
D provide information to enable the trial balance to be prepared

Test your understanding 5

Which of the following does NOT apply to the preparation of financial statements?
A They are prepared annually
B They provide a summary of the outcome of financial transactions
C They are prepared mainly for external users of accounting information
D They are prepared to show the detailed costs of manufacturing and trading
Test your understanding 6

Which of the following sentences does NOT explain the distinction between financial statements and management accounts?

A. Financial statements are primarily for external users and management accounts are primarily for internal users.
B. Financial statements are normally produced annually, and management accounts are normally produced monthly.
C. Financial statements are more accurate than management accounts.
D. Financial statements are required by law and management accounts are not.

Test your understanding 7

Match the following users with their information requirements.

1. Investors  
   A. Firm’s ability to provide goods now and in future and pay debts
2. Lenders  
   B. Performance, profitability and dividends
3. Employees  
   C. Profit levels, tax liability and statistics
4. Business contacts  
   D. Firm’s ability to pay interest and repay loans, the value of secured assets
5. Government departments  
   E. Firm’s ability to pay wages, cash resources, future prospects, pay pensions

Test your understanding 8

Which of the following is a non-profit making entity?

A. Sole trader
B. Tennis club
C. Partnership
D. Corporate entity
Test your understanding 9

Which of the following statements is incorrect?

A A corporate entity may have thousands of owners known as shareholders
B It is possible for a person to be both a shareholder in a corporate entity and a director of that entity
C A partnership must be two or more persons working in common with a view to making a profit
D The shareholders in a corporate entity must be involved with its day-to-day activities and management

Test your understanding 10

The ‘accounting equation’ can be rewritten as:

A assets plus profit less drawings less liabilities equals capital at the end of the accounting period
B assets less liabilities less drawings equals capital at the start of the accounting period plus profit
C assets less liabilities less capital at the start of the accounting period plus drawings equals profit
D capital at the start of the accounting period plus profit less drawings less liabilities equals assets

Test your understanding 11

An increase in inventory of $250, a decrease in the bank balance of $400 and an increase in payables of $1,200 results in:

A a decrease in working capital of $1,350
B an increase in working capital of $1,350
C a decrease in working capital of $1,050
D an increase in working capital of $1,050
Test your understanding 12
A sole trader had opening capital of $10,000 and closing capital of $4,500. During the accounting period, the owner introduced capital of $4,000 and withdrew $8,000 for her own use.

Required:
What was her profit or loss for the accounting period (give your answer in $)?

$. .......

Test your understanding 13
At 1 April 20X3, a business entity had assets of $28,000 and liabilities of $12,500. During April 20X3, the entity purchased a non-current asset for $6,000, paying by cheque, a profit of $7,000 was made, and payables of $5,500 were paid by cheque.

Required:
What was the capital account balance at 30 April 20X3 (give your answer in $)?

$. .......

Test your understanding 14
The accounting equation states that Assets = Liabilities + Capital and this can change as a result of certain transactions.

Which one of the following transactions would not affect the accounting equation?
A Selling goods for more than their cost
B Purchasing a non-current asset on credit
C The owner withdrawing cash
D Receivables paying their accounts in full, in cash

Test your understanding 15
The profit of a business entity may be calculated by using which one of the following formulae?
A Opening capital + drawings + capital introduced – closing capital
B Closing capital + drawings – capital introduced – opening capital
C Opening capital + drawings – capital introduced – closing capital
D Closing capital – drawings + capital introduced – opening capital
### Test your understanding answers

#### Test your understanding 1

<table>
<thead>
<tr>
<th>Date</th>
<th>Assets</th>
<th>Liabilities</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 Jan</td>
<td>Bank $5,000</td>
<td>Nil</td>
<td>$5,000</td>
</tr>
<tr>
<td>1 Feb</td>
<td>Bank $4,200</td>
<td>Van $800</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bank $4,200</td>
<td>Van $800</td>
<td>E Holmes $250</td>
</tr>
<tr>
<td></td>
<td>Inventory $650</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Feb</td>
<td>Bank $4,200</td>
<td>P Smith $400</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Van $800</td>
<td>E Holmes $250</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Inventory $650</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash $600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Feb</td>
<td>Bank $4,200</td>
<td>P Smith $400</td>
<td>Original capital $5,000</td>
</tr>
<tr>
<td></td>
<td>Van $800</td>
<td>E Holmes $250</td>
<td>Profit earned $200</td>
</tr>
<tr>
<td></td>
<td>Inventory $250</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash $600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Feb</td>
<td>Bank $4,400</td>
<td></td>
<td>Original capital $5,000</td>
</tr>
<tr>
<td></td>
<td>Van $800</td>
<td></td>
<td>Profit earned $200</td>
</tr>
<tr>
<td></td>
<td>Inventory $250</td>
<td>E Holmes $250</td>
<td></td>
</tr>
</tbody>
</table>
## The accounting environment

### 5 Feb

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
<th></th>
<th>Original capital</th>
<th>$5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank</td>
<td>$4,400</td>
<td>E Holmes</td>
<td>$250</td>
<td>$500</td>
</tr>
<tr>
<td>Van</td>
<td>$800</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receivable – J</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amos</td>
<td>£200</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receivable – A</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Turner</td>
<td>$300</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(250 – 200)</td>
<td>$50</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$5,750</td>
<td>$250</td>
<td></td>
<td>$5,500</td>
</tr>
</tbody>
</table>

### Test your understanding 2

**B**

Maintaining ledger accounts, producing a trial balance and recording transactions are all part of the bookkeeping system.

### Test your understanding 3

**C**

Recording transactions is part of the bookkeeping function. This should be capable of providing management with internal information, but this is part of the management accounting function. The calculation of profit also results from the bookkeeping system and contributes towards the presentation of the financial results.

### Test your understanding 3

**C**

Management accounts are prepared monthly (or more frequently) for internal control purposes; they also contain detailed information such as costing figures. The trial balance is prepared from the bookkeeping system and is used as a basis for the preparation of financial statements.
### Test your understanding 5

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>D</strong></td>
<td>Management accounts would provide detailed costs and other information regarding manufacturing and trading</td>
</tr>
</tbody>
</table>

### Test your understanding 6

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>C</strong></td>
<td></td>
</tr>
</tbody>
</table>

### Test your understanding 7

<table>
<thead>
<tr>
<th></th>
<th>Answer:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>B</td>
</tr>
<tr>
<td>2</td>
<td>D</td>
</tr>
<tr>
<td>3</td>
<td>E</td>
</tr>
<tr>
<td>4</td>
<td>A</td>
</tr>
<tr>
<td>5</td>
<td>C</td>
</tr>
</tbody>
</table>

### Test your understanding 8

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>B</strong></td>
<td></td>
</tr>
</tbody>
</table>

### Test your understanding 9

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>D</strong></td>
<td>A corporate entity may have many shareholders. For corporate entities listed on a stock exchange, there may be millions of shares in issue, and therefore millions of shareholders. It is possible, although not compulsory, for a shareholder to also be a director of that corporate entity. The definition of a partnership as stated in the question is correct. The position of a shareholder in a corporate entity is quite distinct from those of an employee or director. The final statement is incorrect. There is no requirement for a corporate entity shareholder to be involved in its day-to-day activities – the board of directors are elected to manage the corporate entity on behalf of its shareholders.</td>
</tr>
</tbody>
</table>


Test your understanding 10

C
The 'standard' accounting equation is:
\[ \text{Assets} = \text{Liabilities} + \text{Capital} \]
Capital equals opening capital plus profits less drawings. The only rearrangement of this equation that maintains the integrity of the accounting equation is C.

Test your understanding 11

A
The effect on working capital is calculated as:

\[ \begin{array}{l}
\text{Increase in inventory} = \text{increase in working capital} \\
\text{Decrease in bank} = \text{decrease in working capital} \\
\text{Increase in payables} = \text{decrease in working capital} \\
\text{Overall decrease in working capital}
\end{array} \]
\[ \begin{array}{r}
250 \\
(400) \\
(1,200) \\
(1,350)
\end{array} \]

Test your understanding 12

\[ \begin{array}{l}
\text{Opening capital} \\
\text{Introduced} \\
\text{Drawings} \\
\text{Loss – balancing figure} \\
\text{Closing capital}
\end{array} \]
\[ \begin{array}{r}
10,000 \\
4,000 \\
(8,000) \\
(1,500) \\
4,500
\end{array} \]

Test your understanding 13

Only the profit affects the capital at the end of the month. The capital at the start was $15,500 ($28,000 assets less $12,500 liabilities), so a profit of $7,000 increases this to $22,500. The purchase by cheque of a non-current asset affects only assets, and the payment of payables by cheque affects assets and liabilities, but neither affects capital.
Test your understanding 14

D
The accounting equation changes when one or more of assets, liabilities or capital changes. Selling goods at a profit would change capital; purchasing a non-current asset on credit would change assets and liabilities; the owner withdrawing cash would change assets and capital; receivables paying their accounts in cash would not affect any of these.

Test your understanding 15

B